No. 16496

In the United States Court of Appeals for the Ninth Circuit

WILBUR SECURITY COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petition for Review of the Decision of the Tax Court of the United States

BRIEF FOR THE RESPONDENT

CHARLES K. RICE,
Assistant Attorney General,

LEE A. JACKSON,
ROBERT N. ANDERSON,
MELVIN L. LEBOW,
Attorneys,
Department of Justice,
Washington 25, D. C.

INDEX

CITATIONS

Cases: Page

In the United States Court of Appeals for the Ninth Circuit

No. 16496

WILBUR SECURITY COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petition for Review of the Decision of the Tax Court of the United States

---

BRIEF FOR THE RESPONDENT

OPINION BELOW

The findings of fact and opinion, as amended, of the Tax Court (R. 26-57) are reported at 31 T.C. 938.

JURISDICTION

This petition for review (R. 58-63) involves deficiencies in federal income taxes for the calendar years 1953, 1954 and 1955, in the respective amounts of $13,520.46, $17,254.17, and $17,254.18 (R. 57-58). A notice of deficiency was mailed to the taxpayer on June 7, 1957. (R. 3, 7.) On June 24, 1957, the taxpayer filed a petition for redetermination of

those deficiencies (R. 3-12) under the provisions of Section 6213(a) of the 1954 Code. The decision of the Tax Court was entered on March 13, 1959. (R. 57-58.) The case is brought to this Court by a petition for review filed by the taxpayer on April 24, 1959. (R. 58-63.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Whether the Tax Court's finding, that amounts paid by the taxpayer on a "Bills Payable Account" constituted dividends and not deductible interest, is clearly erroneous.

This in turn depends upon whether there is support in the record for a finding that the amounts outstanding in the "Bills Payable Account" constitute equity capital invested in the taxpayer's business rather than indebtedness of the taxpayer within the meaning of 1939 Code Section 23(b) and 1954 Code Section 163(a).

STATUTE INVOLVED

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.[1]

In computing net income there shall be allowed as deductions:

* * * *

---

[1] Section 163(a) of the Internal Revenue Code of 1954 (26 U.S.C. 1958 ed., Sec. 163), applicable to the taxable years 1954 and 1955 here involved, contains provisions substantially the same as those contained in Section 23(b) of the 1939 Code, and therefore is not included here.

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

*   *   *   *

(26 U.S.C. 1952 ed., Sec. 23.)

STATEMENT

The facts, some of which were stipulated, as found by the Tax Court (R. 27-48) may be summarized as follows:

The taxpayer, Wilbur Security Company, hereinafter sometimes referred to as the Company, is a Washington corporation with its principal office located in the city of Wilbur, Washington. (R. 27.)

In 1915, the city of Wilbur, Washington, a small community of less than 1,100 population, was serviced by a single bank, the Wilbur State Bank, hereinafter referred to as the Bank. The stockholders of the Bank had a large amount of money on deposit with the Bank. The stockholders considered that the existence of such large deposits might attract other banking concerns to the city of Wilbur. To forestall such competition from developing, the stockholders of the bank formed the Company on March 18, 1915. A further purpose of the formation of the Company was to provide an entity which would serve and hold such of the Bank's customers as required long-term

loans that the Bank, under existing restrictions, could not carry. (R. 28.)

As originally constituted, the Company's Articles of Incorporation provided in part as follows (R. 28-32):

> Article Two
>
> The objects for which this corporation are formed are:
>
> * * * *
>
> 3. To charge and collect interest upon money loaned, invested or otherwise handled by it, and to derive profit upon any and all transactions by it, and to collect any share of any profit, result or property involved in any contract or transaction relating to its business.
>
> * * * *
>
> 5. In all ways in its own right, to purchase, acquire, manage, develope, operate, improve, change, exchange, mortgage, lease, pledge, hypothecate, sell and dispose or [sic] properties and interests of all kinds, whether real, personal or mixed and wheresoever situate.
>
> 6. To take, acquire, purchase, own, sell, lease, exchange, pledge, mortgage, hypothecate, grant, improve and otherwise deal in real estate, townsites and divisions, lots or subdivisions thereof, and to issue evidences of interest, title, or right in any such property, either in its own right or its rights under contract.
>
> * * * *
>
> 9. To borrow or raise money upon all bonds, warrants, debentures, investment certificates and other negotiable or transferable instruments, or otherwise, as directed by the board of trustees.

10. To lend money or other property on its own account and to receive notes, obligations and evidences therefor, and conveyances, hypothecations and pledges as security for its repayment or redelivery of the same.

* * * *

Article Three

The capital stock of this corporation shall be Twenty-five thousand ($25,000.00) Dollars, divided into Two Hundred Fifty (250) shares of the par value of One hundred ($100.00) dollars per share.

* * * *

Article Six

The number of trustees of this corporation shall be five and the names and residences of the first trustees who shall manage the affairs of the corporation until the 1st day of July 1915, are J. McPherson, E. L. Farnsworth, Chas. Hudkins, G. Thompson, and E. H. Oswalt, all of Wilbur, Lincoln County, state of Washington.

Article Seven

The capital stock of this corporation may be transferred without restriction to any person already a stockholder therein, but shall not be transferable to any person or party not a stockholder of this company without the affirmative vote, approving such transfer, of at least two-thirds of the capital stock of this company, at a regular or special stockholders' meeting called for that purpose. In case any stockholder desires to sell all or part of the stock held by him to a person not already a stockholder of this

company, he shall notify the secretary of this company in writing, stating the amount of stock he desires to sell and the price asked, and shall attach his stock certificate to such notice and give the name and address of the prospective purchaser, the secretary shall then notify all of the other stockholders of this company, and such stockholders shall have an option on said stock at the price asked for thirty days following such notice. If none of said stockholders shall exercise their right of option at or before the expiration of said thirty days, the secretary of this company shall call a stockholders meeting in the manner provided in the by-laws for the purpose of voting upon such prospective purchaser and in case he shall be elected to become a stockholder of this corporation, the president and secretary thereof shall endorse upon such certificate of stock, under the seal of this corporation, using the form given in Article Eight herein, the fact that such prospective purchaser, naming him, has been duly elected to become a stockholder of this company, and such certificate shall then be returned. In case such prospective purchaser shall not be elected as herein provided, then said certificate shall be returned without such endorsement.

Article Eight

On every certificate of stock issued by this company, the following provision shall be printed thereon, to wit:

According to Article VII of the Articles of Incorporation of this company and an agreement entered into between the holder of this certificate

> and all the other stockholders of this company, this certificate is not transferable until the stockholders of this company have been given an option for thirty days for the purchase thereof and such option expired, nor can this certificate be transferred, except to the stockholders of this company, without the consent of at least two-thirds of the capital stock voted in this company, which consent shall be endorsed hereon and signed by the president and secretary of this corporation, naming the person to whom same may be transferred, and bearing the corporate seal.

The following individuals were the original incorporators of the Company and subscribers of the 250 shares of $100 par value stock authorized by its Articles of Incorporation in the number of shares and amounts indicated:

Subscriber	No. of Shares	Amount
E. L. Farnsworth	120	$12,000
John McPherson	105	10,500
Charles Hudkins	10	1,000
G. Thompson	10	1,000
E. H. Oswalt	5	500

None of this stock was actually paid for or issued at this time. The taxpayer's incorporators subscribed to its stock in proportion to their stock interests in the Bank. (R. 32.)

On April 5, 1915, the taxpayer's subscribers held a special meeting at which time they each advanced amounts of money to the taxpayer as "deposits" and adopted the following amendment to the by-laws regarding the aforesaid deposits (R. 32-33):

Amendment No. 1

Article XII

The Several stockholder of the Wilbur Security Company having this day deposited with the Company the following amounts;

E. L. Farnsworth	$96,000.00	
J. McPherson	84,000.00	
Chas. Hudkins	8,000.00	
G. Thompson	8,000.00	
E. H. Oswalt	4,000.00	$200,000.00

Which sums are to be credited to each Stockholders "Special Stockholders Account" on the books of the Company. These accounts not to be withdrawn by any of said stockholders except by consent of two-thirds of the Capital Stock voted in this Company at any regular or special stockholders meeting.

When any stockholder sells any of his stock it is understood that $800.00 of his "Special Stockholders Account" shall be transferred with each share of stock sold and the proper officer shall make the transfer on the books of the Company at the time the stock is transferred.

This by-law has never been amended by the corporation. (R. 33.)

The $200,000 advanced to the taxpayer on April 5, 1915, by its subscribers had been on open account in the Bank to the credit of each subscriber. Upon its advance to the taxpayer, this amount was immediately redeposited by it in the Bank. (R. 33.)

On December 28, 1916, the taxpayer's board of directors held a special meeting at which time it was decided to set aside $25,000 of its earnings as paid-in

capital. At the same meeting, it was decided to issue stock certificates to the original subscribers thereof. (R. 33.) The minutes of the meeting were as follows (R. 33-34):

> Special meeting of the Trustees of Wilbur Security Company held this day and called to order by J. McPherson President at 3:00 P.M. All directors present. The following resolution was offered and unanimously adopted;—
>
> Whereas the earnings of this Company are in excess of Twenty five thousand dollars:
>
> Therefore be it resolved that $25,000 be set aside as the fully paid capital stock of this Company and that certificates of stock be issued to the several stockholders as a stock dividend as follows:
>
> 1st Dividend.

E. L. Farnsworth	115	shares
J. McPherson	105	"
Chas. Hudkins	10	"
G. Thompson	10	"
E. H. Oswalt	5	"
M. E. Hay	5	"
Total	250	"

> Meeting adjourned.

From 1915 to 1938, the Special Stockholders' Account totaled $200,000 in each year and the Paid-in Capital Account totaled $25,000 in each year, representing 250 shares of $100 par value stock, the only outstanding stock. However, the individual interests in those accounts fluctuated during the period 1915

to 1938 in accordance with the amount of stock each stockholder owned. (R. 34-35.)

In addition to the $200,000 in the Special Stockholders' Account, the taxpayer received various additional sums from 1915 through 1938. These amounts were received from the original subscribers, from stockholders and from nonstockholders. In every case, however, such nonstockholders were members of the immediate families of stockholders. (R. 36.) The accumulation of these amounts and their source during the years 1915 to 1938 were as follows (R. 37):

Year	Farnsworth	Phillips	McPherson	McPherson	McPherson	McPherson
1915	$ 15,000.00	$	$	$	$	$50,000.00
1916	25,000.00		4,000.00			50,000.00
1917	40,000.00		4,000.00			70,000.00*
1918	61,000.00	4,933.15	13,000.00	36,000.00	36,000.00	
1919	95,000.00	6,568.98	25,000.00	28,500.00	23,900.00	
1920	114,950.00	11,515.46	34,000.00	21,000.00	25,900.00	
1921	108,000.00	13,835.16	58,000.00	34,581.12	63,500.00	
1922	107,000.00	14,994.26	52,500.00	31,000.00	53,000.00	
1923	110,000.00	21,224.56	61,000.00	35,000.00	58,500.00	
1924	95,500.00	20,000.00	66,000.00	38,000.00	61,000.00	
1925	89,000.00	20,000.00	69,000.00	43,000.00	64,000.00	
1926	102,000.00	10,000.00	55,000.00	47,000.00	69,000.00	
1927	98,000.00		55,000.00	50,500.00	69,000.00	
1928	90,000.00		64,750.00	54,500.00	73,000.00	
1929	90,000.00		66,000.00	57,500.00	75,000.00	
1930	100,679.35		72,722.65	75,388.30	97,753.70	
1931	104,000.00		72,700.00	74,700.00	98,100.00	
1932	104,000.00		74,100.00	74,300.00	97,220.00	
1933	103,800.00		72,950.00	74,200.00	96,970.00	
1934	102,600.00		69,950.00	74,050.00	95,790.00	
1935	100,944.05		66,000.00	74,050.00	95,390.00	
1936	88,141.55	10,000.00	64,000.00	74,050.00	95,390.00	
1937	87,890.55		64,200.00	78,050.00	96,390.00	
1938	97,790.55		78,000.00	81,050.00	99,390.00	

* Transferred to the following from estate:

J. McPherson	$ 3,000.00
Kate McPherson	33,500.00
Julia McPherson	33,500.00

Non-stockholders did not participate in management or in voting for the taxpayer's officers. The $200,000 in the Special Stockholders' Account, the $25,000 in the Paid-in Capital Account, and the monies in the Special Account were invested in loans upon notes and mortgages, primarily upon real estate (farm properties), in which the Bank was unable to invest. When some of the obligors could not meet the payments on the notes and mortgages, the taxpayer acquired title to the properties which had been held as the security for the loans. The acquisition of these farm properties occurred during the years 1929 through 1933 and their combined book value was from $437,039.41 to $445,594.72, whereas the fair market value was estimated to be in excess of $1,500,000 during the years in question. The operation of these properties constituted the taxpayer's principal source of income. (R. 38-39.)

The taxpayer's surplus, dividends, salaries, interest paid on obligations not in issue, and amounts paid on the Special Account and Special Stockholders' Account from 1915 through 1938 were as follows (R. 39):

Year	Surplus	Dividends	Salaries	Interest Paid on Obligations not in Issue	Amts. Paid on Spec. Acct. and Special Stockholder's Acct.
1915	$ 5,058.53	$ None	$ None	$ None	$ 388.77
1916	2,228.81	25,000.00	None	None	3,701.45
1917	728.69	18,000.00	7,840.00	None	4,837.50
1918	105.43	20,000.00	6,480.00	100.00	6,279.20
1919	792.46	17,500.00	4,400.00	1,335.72	7,714.30
1920	1,876.19	7,500.00	4,400.00	8,253.93	8,770.00
1921	19,122.53	None	2,400.00	4,993.09	12,645.40
1922	18,142.34	None	4,675.00	654.60	13,341.60
1923	18,422.58	None	None	623.67	14,902.19
1924	17,855.34	None	None	118.68	12,595.15
1925	17,384.09	2,500.00	None	150.00	13,255.67
1926	21,542.22	5,000.00	None	1,348.42	13,339.12
1927	36,219.85	None	None	475.00	13,684.36
1928	48,901.34	None	None	None	12,552.66
1929	49,969.10	None	None	570.87	12,841.30
1930	53,776.75	None	None	3,152.70	13,044.00
1931	53,063.90	None	None	1,831.88	5,607.93
1932	49,636.64	None	None	1,984.60	None
1933	49,486.08	None	None	387.33	None
1934	48,861.34	None	None	80.33	None
1935	47,689.40	None	None	None	None
1936	48,675.20	None	None	None	None
1937	48,685.46	12,500.00	2,200.00	1,172.38	15,760.00
1938	48,687.22	9,585.00	None	None	16,428.00

In 1939, the taxpayer's income tax returns for 1937 and 1938 were examined by the Commissioner and a deficiency in income tax was proposed for that year on the basis of a disallowance of the interest deduction taken for the interest paid to the stockholders on the amounts in the Special Stockholders' Account. The taxpayer filed a protest to the proposed determination and a subsequent agreement was

reached whereby the tax returns were accepted as correct. (R. 39-40.)

On June 5, 1939, a special meeting of the taxpayer's stockholders was held in which a resolution was adopted. The minutes of the meeting were, in part, as follows (R. 40):

> It was duly moved, seconded and carried unanimously that the Stockholders Accounts on books of Wilbur Security Company, which total $200,000.00 shall be paid off and distributed to the owners thereof, viz:

J. McPherson	Stockholders Account	$102,000.00
E. L. Farnsworth,	Stockholders Account	72,000.00
G. Thompson,	Stockholders Account	16,000.00
E. H. Oswalt,	Stockholders Account	6,000.00
Elizabeth McPherson	Stockholders Account	4,000.00
		$200,000.00

> and further, that the Secretary of Wilbur Security Company, G. Thompson, is hereby directed and empowered to pay off and distribute the said Stockholders Accounts to the owners thereof.

The $200,000 was withdrawn from the Special Stockholders' Account and the same amount was redeposited with the other funds in the Special Account. This transaction was accomplished by bookkeeping entries without transferring cash between the taxpayer and the stockholders. From this time on, only stockholders and members of the immediate families of stockholders held interests in the Special Account. (R. 40-41.)

On January 20, 1943, the taxpayer's board of directors passed a resolution which provided, in part, as follows (R. 41):

> It was duly moved, seconded and carried that all our Special Accounts Payable, on which we pay interest, shall be changed over to Bills Payable, as of January 1, 1943. That the Secretary shall prepare proper notes of the Wilbur Security Company for each of said Special Accounts Payable, dating same January 1, 1943, due one year after date, and bearing interest at rate of 5 per cent per annum. That, these said Bills Payable shall be signed for the Company by its [sic] President and attested by its Secretary.

Following this action, the secretary prepared bills payable to the respective holders of interests (who were all stockholders or members of their immediate families) in the new Bills Payable Account, to pay 5% interest for one year. At the end of each year thereafter, up to 1955, the taxpayer's directors renewed these bills to pay a specified rate of interest or cancelled the old notes and issued new notes for the same amounts without approval from those nonstockholders who held interest in the Bills Payable Account. The directors endeavored to fix the interest rate annually so that it would be slightly above that of the prevailing rate paid by lending institutions. At the same time, in fixing the annual interest rate, the directors took into account the taxpayer's earnings. The notes remained in the taxpayer's possession at all times and none of the nonstockholders ever saw them, although some knew of them. (R. 41-42.)

The notes executed for 1952, on December 31, 1951, were originally issued to provide for 5% interest per annum. On November 4, 1952, the board of directors increased this interest rate to 6%. In 1956 the nomenclature of this account was changed to Notes Payable at the advice of Laurence D. Morse, the certified public accountant who handled the books of the taxpayer, because the term Bills Payable was deemed to be old-fashioned. (R. 42.)

The status of the Bills Payable Account from 1939 to 1955 and a comparison of that account to the stock account for those years were (R. 42) as follows (R. 43-44):

Year	E. L. Farnsworth	Sarah A. Farnsworth	Grace Phillips	J. McPherson	G. Thompson
1939	$169,790.55—90	$	$	$190,000.00—122½	$16,000.00—20
1940	157,790.55—90			187,000.00—122½	16,000.00—20
1941	81,081.47	73,096.74—90		171,000.00—102½	16,000.00—20
1942		99,829.80—90	44,298.60	144,000.00—102½	16,000.00—20
1943		96,829.80—90	50,298.60	144,000.00—102½	16,000.00—20
1944		93,829.80—90	53,298.60	144,000.00—102½	16,000.00—20
1945		90,829.80—90	56,298.60	144,000.00—102½	16,000.00—20
1946		75,829.80—90	71,298.60	144,000.00—102½	16,000.00—20
1947		72,829.80—90	74,298.60	144,000.00—102½	16,000.00—20
1948		69,829.80—90	77,298.60	144,000.00—102½	16,000.00—20
1949		66,829.80—90	80,298.60	144,000.00—102½	16,000.00—20
1950		63,829.80—90	83,298.60	144,000.00—102½	16,000.00—20
1951		63,829.80—90	83,298.60	144,000.00—102½	16,000.00—20
1952		63,829.80—90	83,298.60	144,000.00—102½	16,000.00—20
1953		63,829.80—90	83,298.60	144,000.00—102½	16,000.00—20
1954		63,829.80—90	83,298.60	144,000.00—102½	16,000.00—20
1955			147,128.40—90	144,000.00—102½	16,000.00—20

Year	E. H. Oswalt	Elizabeth McPherson	J. K. McPherson	Kate McPherson	Julia McPherson	Catherine Bernhard
1939	$6,000.00—7½	$4,000.00—5	$ 8,000.00—5	$87,000.00	$99,390.00	$
1940	6,000.00—7½	4,000.00—5	8,000.00—5	87,000.00	99,390.00	
1941	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	
1942	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1943	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1944	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1945	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1946	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1947	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1948	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1949	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1950	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1951	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1952	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1953	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1954	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00
1955	6,000.00—7½	4,000.00—5	24,000.00—25	87,000.00	99,390.00	25,000.00

The monies in the Grace Phillips account prior to 1940 were deposited there for her by E. L. Farnsworth, her father, who took care of her finances. In 1940, E. L. Farnsworth died and his stock, plus an amount in excess of $800 per share, was then transferred to the account of Sarah A. Farnsworth, his widow. Of the remaining funds left in the Special Account to the account of E. L. Farnsworth, approximately $69,000 was used to pay inheritance taxes. Sarah A. Farnsworth died in 1951. Her stock and interest in the then Bills Payable Account were held under that name until 1954 when they were transferred to the account of Grace Phillips, her daughter. On January 1, 1953, the taxpayer disbursed $14,000 to Grace Phillips, as executrix of the Estate of Sarah A. Farnsworth, for the purpose of settling that estate. The total of Bills Payable for the year was shown as the gross amount undiminished by the $14,000 on the balance sheet, but the minutes of the directors' meeting and the 1953 tax return reflect both the gross amount and the net amount in that account. The $14,000 was redeposited with the taxpayer on January 4 and 12, 1954, by Grace Phillips to the credit of the estate. (R. 45.)

The relationship between stockholders, and between stockholders and those owning interests in the Bills Payable Account was as follows (R. 46):

D. K. McPherson	
J. McPherson	Son of D. K. McPherson
Kate McPherson	Daughter of D. K. McPherson
Julia McPherson	Daughter of D. K. McPherson
Elizabeth McPherson	Wife of J. McPherson
J. K. McPherson	Son of J. McPherson

Catherine Bernhard	Daughter of J. McPherson
E. L. Farnsworth	
Sarah A. Farnsworth	Wife of E. L. Farnsworth
Grace L. Phillips	Daughter of E. L. Farnsworth

The members of the McPherson and Farnsworth families have maintained a close, friendly relationship through the years. (R. 46.)

From 1941 to 1955 the members of the board of trustees (or directors) consisted of five of the stockholders, as provided for by the by-laws. These were (R. 46):

John McPherson	Godfrey Thompson
John K. McPherson	Grace L. Phillips
E. H. Oswalt	

The taxpayer's officers from 1941 to 1955 were as follows (R. 46):

John McPherson	President
J. K. McPherson	Vice President
Godfrey Thompson	Secretary

The taxpayer's surplus, dividends, salaries, interest paid on obligations not in issue, and interest paid on the Special Account or Bills Payable Account from 1939 through 1955 (R. 46) were as follows (R. 47):

ear	Surplus	Dividends	Salaries	Interest Paid on Obligations not in Issue	Amts. Paid on Spec. Acct. or Bills Payable Acct.
939	$ 51,367.39	$ 5,000.00	$ None	$ None	$17,016.90
940	52,734.52	7,500.00	None	None	17,195.40
941	56,741.77	7,500.00	None	203.33	21,559.50
942	75,819.90	7,500.00	5,000.00	162.90	27,475.92
943	69,140.93	7,500.00	5,000.00	None	27,596.75
944	73,864.99	7,500.00	5,000.00	None	27,625.92
945	79,082.44	7,500.00	5,000.00	None	27,625.92
946	84,553.48	25,000.00	8,000.00	None	27,625.92
947	98,158.21	25,000.00	12,000.00	None	27,625.92
948	105,328.30	25,000.00	18,000.00	None	27,625.92
949	109,838.21	25,000.00	18,000.00	None	27,625.92
950	128,977.48	25,000.00	18,000.00	None	27,625.92
951	129,107.95	25,000.00	18,000.00	None	27,625.92
952	147,238.25	25,000.00	18,000.00	None	33,151.10
953	147,541.62	25,000.00	18,000.00	None	32,311.10
954	164,121.39	25,000.00	18,000.00	None	33,151.10
955	166,872.50	25,000.00	18,000.00	None	33,151.10

The taxpayer's balance sheet for the years in question was as follows (R. 47-48):

SSETS	1953	1954	1955
Current Assets			
Cash in bank	$ 2,315.55	$ 54,938.74	$ 35,119.82
Bills Receivable	304,095.73	269,161.64	283,176.36
Investment in Stocks	500.00	500.00	500.00
Fixed Assets			
Farm properties and buildings	438,148.74	437,039.41	445,594.72
Total assets	$745,060.02	$761,639.79	$764,390.90

LIABILITIES AND CAPITAL	1953	1954	1955
Current Liabilities			
Income tax payable, estimated	$ 20,000.00	$ 20,000.00	$ 20,000.00
Notes payable	552,518.40	552,518.40	552,518.40
Capital			
Capital stock	25,000.00	25,000.00	25,000.00
Surplus	147,541.62	164,121.39	166,872.50
Total liabilities and capital	$745,060.02	$761,639.79	$764,390.90

The Commissioner disallowed all interest deductions for monies paid as interest on the Bills Payable Account and determined that the account represented the actual invested capital of the taxpayer. (R. 48.)

The Tax Court found that the amounts outstanding in the taxpayer's Bills Payable Account constituted equity capital invested in its business, and that the payments of $32,311.10 in 1953, $33,151.10 in 1954, and $33,151.10 in 1955 on the Bills Payable Account were distributions of dividends. (R. 48.)

SUMMARY OF ARGUMENT

A. The taxpayer paid what is alleged to be "interest" to certain individuals who advanced money to it in order for it to start and pursue its corporate business and acquire income-producing properties. The taxpayer deducted these disbursements on its tax returns, claiming that they were paid on account of an "indebtedness" within the meaning of Section 23(b) of the 1939 Code. The trial court found, however, that as a matter of fact the advances represent

capital contributions to the taxpayer rather than debts, and, secondly, that the disbursements to noteholders constitute non-deductible dividend payments. The question whether advances to a corporate taxpayer constitute capital investments or indebtedness is one of fact and the trial court's finding is final unless clearly erroneous. Not only is the Tax Court's finding here *not* clearly wrong, but it is *fully* supported by the record.

Contrary to the taxpayer's argument, the fact that advances are evidenced by notes having definite maturity dates and a fixed obligation to pay interest does not end the controversy. That is so because those formalisms may not represent the true agreement of the parties, or may only partially represent such agreement. The question being one of substance over form, it matters not what the parties call their transaction—if the evidence taken as a whole shows a stockholding relationship the advances cannot be treated as debts. This factual determination must take into consideration the history of the notes, their treatment by the parties, and all of the surrounding circumstances.

Each case must be decided upon its own facts and hence there are no all-inclusive rules to be applied. However, the trial court is guided in its determination by many judicial signposts recognized by the appellate courts. Each of those signposts represents either an *indicium* of a stockholding relationship or an *indicium* of a debtor-creditor relationship. The taxpayer, seeking a deduction, bears the burden of showing that the preponderance of circumstances are

those which are characteristic of a debtor-creditor relationship.

B. Two groups of individuals advanced money to the taxpayer and held its notes, namely, those who held certificates of stock and those who did not. The Tax Court properly held that the taxpayer's payments to each constituted dividends and not deductible interest.

1. The notes which the taxpayer issued to shareholders for their advances do not to any extent represent the true circumstances. Considering all of the record facts, the preponderance of the evidence indicates a stockholding relationship, and the characteristics of a debtor-creditor relationship are almost nonexistent. Some of the factors showing that the payments in question constituted dividends rather than interest are as follows: There was in fact no fixed maturity date (notwithstanding the provisions of the notes that shareholders held, the advances remained with the taxpayer for indefinite periods which up through the taxable years in question amounted in some instances to approximately four-fifths of its corporate life of fifty years); so-called "interest" payments depended upon the taxpayer's earnings; the determination of whether interest would be paid and the amount thereof was solely in the discretion of the taxpayer's board of directors; the notes were not paid on due dates; there was no attempt to enforce payment of the notes though due dates were annually violated; the advances were used broadly to enable the taxpayer to start its business and acquire *all* of its income-producing properties; the ad-

vances were unsecured; the notes were in fact not negotiable because they never left the taxpayer's possession; and outsiders would not have made the advances under like circumstances, to wit, for an indefinite length of time, in effect subject to the risks of the business, and the return thereon being exclusively within the discretion of the taxpayer's board of directors.

The factors summarized constitute almost all of the well-recognized earmarks of venture or risk capital and it is obvious that the Tax Court's finding, after a painstaking review of all the evidence, that the interest of the shareholders who also held notes was an equity interest and the taxpayer's disbursements on account thereof constitute non-deductible dividends, is not clearly erroneous.

2. The Tax Court's finding that advances made to the taxpayer by members of the immediate families of stockholders also constituted contributions to capital is likewise fully supported by the record and not clearly erroneous. The same circumstances described as existing with respect to advances made by shareholders exist here; that is, the characteristics of a stockholding relationship prevail while almost none of the characteristics of a debtor-creditor relationship are to be found.

Contrary to the taxpayer's apparent position, since the overwhelming weight of the evidence shows that the interests of these noteholders were equity interests, the fact that the notes did not confer the right to vote does not require, as a matter of law, a finding

different from that made by the Tax Court. Many stock interests, such as preferred stock, do not confer the right to vote or to participate in management, but nevertheless the holders of such interests are *not* creditors of the corporation.

Moreover, it is to be noted that it is not necessary, in order for an equity or stock interest to exist, that the formalisms of a stock issue be observed. If advances are such that they are accompanied with a preponderance of characteristics which accord with a stockholding relationship, the holder of notes representing those advances is treated as a stockholder under the Code.

ARGUMENT

THE TAX COURT'S FINDING, THAT THE AMOUNTS OUTSTANDING IN THE TAXPAYER'S "BILLS PAYABLE ACCOUNT" CONSTITUTE EQUITY CAPITAL INVESTED IN ITS BUSINESS AND THAT PAYMENTS MADE BY THE TAXPAYER TO THOSE WHO OWNED AN INTEREST IN THAT ACCOUNT WERE NON-DEDUCTIBLE DISTRIBUTIONS OF DIVIDENDS, IS FULLY SUPPORTED BY THE RECORD AND NOT CLEARLY ERRONEOUS

A. The principles involved

This case involves the oft-litigated issue as to whether payments made by a corporation to those who have advanced funds to it constitute dividends or interest. The taxpayer contends that the payments constitute interest and that, therefore, it can deduct the disbursements under Section 23(b) of the

Internal Revenue Code of 1939, *supra.*[2] However, if the payments were in reality distributions of corporate profits on account of the recipients' investments in the corporate business, then the disbursements are not deductible.

Of course, since deductions are a matter of legislative grace, the taxpayer bears the burden of showing clearly that the questioned disbursements constitute interest payments. The question is necessarily factual and the finding of the trial court is final unless "clearly erroneous". *O'Neill* v. *Commissioner*, 271 F. 2d 44 (C.A. 9th); *Earle* v. *W. J. Jones & Son*, 200 F.2d 846, 847 (C.A. 9th); *Gooding Amusement Co.* v. *Commissioner*, 236 F. 2d 159, 166 (C.A. 6th), certiorari denied, 352 U. S. 1031; *Matthiessen* v. *Commissioner*, 194 F. 2d 659, 662 (C.A. 2d); *Bair* v. *Commissioner*, 199 F. 2d 589, 591 (C.A. 2d). Moreover, since many types of equity interests are similar to an indebtedness in that the holder of the obligation is preferred over other stockholders and has no right to vote or participate in management, the question is sometimes a close one involving the weighing of many factors to arrive at the practical effect of all the circumstances. We here summarize the approach uniformly taken by the courts that have considered the question.

---

[2] For convenience, we refer in our argument only to Section 23(b) of the 1939 Code; however, Section 163(a) of the Internal Revenue Code of 1954 (26 U.S.C. 1958 ed., Sec. 163), which contains provisions substantially the same as those found in 1939 Code Section 23(b), applies to the taxable years 1954 and 1955 here involved.

The classic debt is an unqualified obligation to pay a sum certain at a fixed maturity date, with a fixed percentage of interest, payable regardless of the debtor's income or lack thereof. Congress when using the term "indebtedness" in the Code uses it in its ordinary sense, that is, the advances must in fact be of the nature of an indebtedness. Accordingly, where advances are substantially lacking in the attributes of the classic debt they will be precluded from treatment as such under the federal taxing statute (*241 Corp.* v. *Commissioner*, decided July 25, 1956 (1956 P-H T.C. Memorandum Decisions, par. 56,174), affirmed *per curiam*, 242 F. 2d 759 (C.A. 2d), certiorari denied, 354 U.S. 938; *Beaver Pipe Tools, Inc.* v. *Carey*, 139 F. Supp. 470, 471-472 (N.D. Ohio), affirmed *per curiam*, 240 F. 2d 843 (C.A. 6th), certiorari denied, 353 U.S. 958; *Root* v. *Commissioner*, 220 F.2d 240, 241 (C.A. 9th); *May Hosiery Mills* v. *Commissioner*, 123 F.2d 858, 860 (C.A. 4th); *Haffenreffer Brewing Co.* v. *Commissioner*, 116 F. 2d 465, 468 (C.A. 1st), certiorari denied, 313 U.S. 567; *Jewel Tea Co.* v. *United States*, 90 F.2d 451, 453 (C.A. 2d)); however, a slight variation will not of itself preclude such treatment (see *Miller's Estate* v. *Commissioner*, 239 F.2d 729 (C.A. 9th); *United States* v. *Title Guarantee & Trust Co.*, 133 F.2d 990, 995 (C.A. 6th)).

On the other hand, the fact that advances take the *form* of debts in all details does not end the controversy. If, for example, the notes are a mere pretense in that the parties actually entered into an *entirely* different agreement by which their rights

were to be governed, then there is not even a need to apply the various judicial guides which have arisen in this area to answer the question, for it would be clear that the notes represent mere formalisms disguising the true relationship. The *motive* for so disguising the transaction is immaterial—the significant point is that in reality the recognized and fundamental earmarks of a debt which is represented by the notes are missing. *Gilbert* v. *Commissioner*, 248 F.2d 399, 404, 408 (C.A. 2d). However, if the notes do not represent pure formalisms, but in part truly evidence *some* of the characteristics of a debtor-creditor relationship, then the question is still whether the evidence, taken as a whole, shows a stockholding relationship. *Brinker* v. *United States*, 116 F. Supp. 294, 297 (N.D. Cal.), affirmed *per curiam*, 221 F.2d 478 (C.A. 9th); *Gilbert* v. *Commissioner*, 262 F.2d 512, 513 (C.A. 2d), certiorari denied, 359 U.S. 1002; *Gilbert* v. *Commissioner*, 248 F.2d 399, 403 (C.A. 2d); *Reed* v. *Commissioner*, 242 F.2d 334, 335 (C.A. 2d); *Sarkes Tarzian, Inc.* v. *United States*, 240 F.2d 467, 470 (C.A. 7th); *United States* v. *Title Guarantee & Trust Co.*, 133 F.2d 990, 995 (C.A. 6th). In that event the question is determined by many factors each of which represents either an *indicium* of a stockholding relationship or an *indicium* of a debtor-creditor relationship. No one characteristic here is controlling—the decision must be reached by a weighing of the factors in the particular record under scrutiny. *John Kelley Co.* v. *Commissioner*, 326 U. S. 521, 530; *Earle* v. *W. J. Jones & Son*, 200 F.2d 846, 847 (C.A. 9th); *Lee Telephone Co.* v. *Commissioner*,

decided December 16, 1957 (1957 P-H T.C. Memorandum Decisions, par. 57,230), affirmed, 260 F.2d 114 (C.A. 4th); *Reed* v. *Commissioner*, 242 F.2d 334, 335 (C.A. 2d); *Gooding Amusement Co.* v. *Commissioner*, 236 F. 2d 159, 165 (C.A. 6th), certiorari denied, 352 U.S. 1031; *Crawford Drug Stores, Inc.* v. *United States*, 220 F.2d 292, 296 (C.A. 10th).

From the foregoing it is readily apparent that, although advances may take the form of debts, and although a shareholder may testify that he did not intend to make a capital investment, the facts may show that the advances were in their fundamental nature venture or risk capital, and since such attributes were intended, there was a stockholding relationship under the taxing statute. *Beaver Pipe Tools, Inc.* v. *Carey*, 139 F. Supp. 470, 472 (N.D. Ohio), affirmed *per curiam*, 240 F. 2d 843 (C.A. 6th), certiorari denied, 353 U.S. 958; *Gilbert* v. *Commissioner*, 248 F.2d 399, 406-407 (C.A. 2d); *Gilbert* v. *Commissioner*, 262 F.2d 512, 514 (C.A. 2d), certiorari denied, 359 U.S. 1002; *Elko Lamoille Power Co.* v. *Commissioner*, 50 F.2d 595, 596 (C.A. 9th); cf. *Starr* v. *Commissioner* (C.A. 9th), decided December 29, 1959 (60-1 U.S.T.C., par. 9191).

In short, the basic inquiry is aimed at ascertaining whether the advances were in reality an investment in the business, the return thereon being based upon the risk of the venture, or whether they were based on a definite obligation of the taxpayer to provide a return in any event within reasonable and fixed periods of time. *Root* v. *Commissioner*, 220 F.2d 240, 241 (C.A. 9th); *Arlington Park Jockey Club* v.

Sauber, 262 F.2d 902, 905 (C.A. 7th); *Beaver Pipe Tools, Inc.* v. *Carey*, 139 F. Supp. 470, 471-472 (N.D. Ohio), affirmed *per curiam*, 240 F. 2d 843 (C.A. 6th), certiorari denied, 353 U.S. 958; *Dittmar* v. *Commissioner*, 23 T.C. 789, 797.

In accordance with the distinctions discussed, the courts, as previously noted, have decided that certain guides should be applied by the finder of fact (none being controlling and not all being found in any one given case), some of which are as follows: whether there was in fact a fixed date for payment of interest and for repayment of principal; whether payments depended upon earnings; whether notes were paid on their maturity dates; whether there was any attempt to enforce payment on due dates; the use to which the advances were put; whether outsiders would have made the advances under like circumstances; whether the advances were secured; whether the notes were negotiable; whether there was participation in management; the formal designation used by the parties; if the parties making the advances were formal stockholders, whether the advances were in proportion to stockholdings; and the relationship between advances which were concededly risk capital and those which were denoted as debts (the debt-equity ratio).[3]

---

[3] Some of the cases applying and discussing these standards are: *Root* v. *Commissioner*, 220 F.2d 240 (C.A. 9th); *Arlington Park Jockey Club* v. *Sauber*, 262 F.2d 902 (C.A. 7th); *Gilbert* v. *Commissioner*, 262 F.2d 512 (C.A. 2d), certiorari denied, 359 U.S. 1002; *Kolkey* v. *Commissioner*, 27 T.C. 37, affirmed, 254 F.2. 51 (C.A. 7th); *Gilbert* v. *Commissioner*, 248 F.2d 399 (C.A. 2d); *Crawford Drug*

The Tax Court applied the principles discussed to the record, and, performing its function as the trier of fact, after a painstaking review of all the evidence, found that the advances in question constituted capital investments in the taxpayer's business. (R. 49-56.) Accordingly, it concluded that the taxpayer's disbursements to holders of the notes in question constituted dividends not deductible by the taxpayer as interest under Section 23(b) of the 1939 Code. (R. 48, 56.) Since some of the holders of notes to which the taxpayer made the disbursements in question were holders of stock certificates and some were not, we will discuss the two groups separately under Point B, *infra*, although the Tax Court reached the same conclusion as to each.

B. The Tax Court correctly found that the taxpayer's disbursements which it deducted as interest under Section 23(b) of the 1939 Code were non-deductible dividend payments

1. The payments by the taxpayer to shareholders because of their advances made to it constitute dividends

During the taxable years 1953, 1954 and 1955, the taxpayer paid what it alleges to be "interest" to holders of its notes who were also its stockholders. On its tax returns for those years the taxpayer deducted those payments, under Section 23(b) of the

---

Stores, Inc. v. *United States,* 220 F.2d 292 (C.A. 10th); *Harkins Bowling, Inc.* v. *Knox,* 164 F. Supp. 801 (Minn.), appeal dismissed (C.A. 8th), January 19, 1959; *Hoguet Real Estate Corp.* v. *Commissioner,* 30 T.C. 580.

1939 Code, as being allegedly incurred on account of "indebtedness". (R. 48.) The Tax Court found (R. 48, 55, 56), however, that the taxpayer did not carry its burden of showing by a preponderance of the evidence that the advances made by the shareholders were not advances of additional capital, but, on the contrary, the preponderance of the evidence shows that the advances were equity capital invested in the taxpayer's business and that the amounts paid on account of those advances constituted dividends and not deductible interest.

The taxpayer attacks the findings of fact by the Tax Court on the ground that, if attention is directed only to the form of the transaction during the taxable years in question, none of the characteristics of a stockholding relationship exist because the notes issued by it were absolute on their face, having a definite maturity date of one year and a definite obligation to pay a fixed rate of interest. (Br. 10-13, 18-22.) In this manner the taxpayer seeks to pursue formalisms and ignore substance, but as we shall show, the notes here do not represent the substance of the transaction to any degree, and, as the trial court observed (R. 55), they merely serve to disguise the true nature of the amounts contained in the taxpayer's "Bills Payable Account".[4]

---

[4] It should be noted, however, that the *motive* for issuing notes which do not represent the true relationship of the parties is immaterial. The crucial fact is, as discussed under Point A, *supra,* that the notes are artificial in that they do not represent the true circumstances—whether the motive initially was to avoid taxes or not, the fact is that

Of course, the taxpayer's attempt to obscure substance by emphasizing formalities can not be reconciled with the cases previously cited. See Point A, *supra.* The settled rule is that the courts are not limited to formalisms, however meticulously observed, in which the parties cast their transactions. The trial court's duty, made necessary by the Congressional enactment of Section 23(b), is to determine whether the taxpayer's deduction of alleged "interest" payments was proper; to do this, it must determine whether the taxpayer has clearly shown that the payments were made on account of an "indebtedness" within the meaning of the Code. In reaching its determination that court is not required to close the judicial eyes to what all others can see. Accordingly, the determination of the question *must* take into consideration the history of the notes, their treatment by the parties, and all of the surrounding circumstances. *John Kelley Co.* v. *Commissioner*, 326 U.S. 521, 526; *Brinker* v. *United States*, 116 F. Supp. 294, 297 (N.D. Cal.), affirmed *per curiam*, 221 F.2d 478 (C.A. 9th); *Lockwood Realty Corp.* v. *Commissioner*, decided March 31, 1958 (1958 P-H T.C. Memorandum Decisions, par. 58,049), affirmed *per curiam* on this issue, 264 F.2d 241 (C.A. 6th); *Kolkey* v. *Commissioner*, 27 T.C. 37, 57, affirmed, 254 F.2d 51 (C.A. 7th); *Gregg Co. of Delaware* v. *Commissioner*, 239 F.2d 498, 502 (C.A. 2d), certi-

---

at this point the taxpayer alleges that the form is supreme and that the substance may be hidden by that form. See *Gilbert* v. *Commissioner*, 262 F.2d 512, 514 (C.A. 2d), certiorari denied, 359 U.S. 1002.

orari denied, 353 U.S. 946. Cf. *Ehrman* v. *Commissioner*, 120 F.2d 607, 610 (C.A. 9th), certiorari denied, 314 U.S. 668; *Lockhart* v. *Commissioner*, 258 F. 2d 343, 348 (C.A. 3d).

(a) *The history of shareholder advances from 1915 to 1943*

The taxpayer was incorporated on March 18, 1915, for the purpose of holding long-term paper which the Wilbur State Bank was not permitted to carry. (R. 28.) Additionally, it was given the power to hold and operate real estate properties. (R. 29.) The corporate life was to exist for 50 years from the date of incorporation. (Ex. 5-E.)[5] During the taxable years in question, the taxpayer carried on its books a "Bills Payable Account" and the major portion of the advances which constituted that account was donated by stockholders. (R. 43-44.) Of the amount advanced by stockholders, $200,000 was advanced on April 5, 1915, and was held in a "Special Stockholders' Account" from 1915 through 1938. (R. 34.) That amount was advanced by the stockholders in direct proportion to the amount of stock each owned, that is, the advances represented $800 for each share of stock. These accounts could not be withdrawn by any of the stockholders except by consent of two-thirds of the capital stock voted in the taxpayer at any regular or special stockholders' meeting. (Ex. 6-F; R. 32-33.) Additionally, if any stock was sold, $800 of the advances were required to be

---

[5] Copies of all exhibits referred to in this brief are being submitted, in quadruplet, for the use of the Court.

transferred with each share of stock thus sold. (R. 33, 35.) These regulations with respect to the initial $200,000 advance were in existence during the taxable years in question. (R. 33, 53.) In addition, the stockholders advanced other monies to an account of the taxpayer titled the "Special Account". (R. 36-37, 40.)

At the time the shareholders advanced the $200,000 discussed above, the taxpayer was possessed of no paid-in capital (R. 163); however, by December of 1916 the taxpayer had accumulated earnings of $25,000, and that money was set aside as paid-in capital (R. 33).

In 1939 the advances represented by the "Special Stockholders' Account", which were always kept in exact proportion to stock ownership, were transferred to the "Special Account". From this time on all of the advances of the stockholders were kept in one consolidated account. (R. 34-35, 40-41.) The proportionate interest of stock to the original advance which was made part of the "Special Account" continued. The consolidation of the accounts occurred after the Commissioner examined the taxpayer's books and questioned the interest payments. (R. 53.) The consolidation of the accounts was understood by the stockholders as being a mere book transaction, in that all that was done was that the two accounts were moved together. (R. 154, 178-179.)

The situation remained as outlined until the year 1943. Up to that period those who remained stockholders allowed their advances to stay with the taxpayer for more than one-half of its corporate life.

(R. 35-37, 41, 43-44; Ex. 5-E.) So far as the record shows, during this period the shareholders received no security for any of their advances; they received no evidence of any indebtedness; there was no fixed maturity date for repayment of principal; there was no obligation on the part of the taxpayer to pay interest at any rate, no less a fixed rate; and there was no right to enforce repayment of the amounts advanced. (R. 51-53, 142, 186-187.) Moreover, although during bad times the shareholders received no return on their advances, other creditors received a return on their loans. (R. 39.) The shareholders understood that, as in the case of their dividends, they could expect no return in bad years. (R. 136.) Any so-called interest payments that were received by the shareholders during this period were obviously at the sole discretion of the directors of the taxpayer and, so far as the record discloses, the shareholders made no demand for payment of interest, or repayment of principal.

At this juncture in the case, it is crystal clear that the shareholders' advances did not constitute debts upon which payments of "interest" may be deducted under the Code. The advances completely lacked all of the signposts of a debtor-creditor relationship. Thus, there did not exist an unqualified obligation to pay a sum certain at a fixed maturity date, with a fixed percentage of interest, payable regardless of the debtor's income or lack thereof. Hence, as a matter of law, the payments in question which the taxpayer made to shareholders were not made on account of an "indebtedness" within the meaning of 1939 Code Sec-

tion 23(b). *Root* v. *Commissioner*, 220 F.2d 240, 241 (C.A. 9th); *Beaver Pipe Tools, Inc.* v. *Carey*, 139 F. Supp. 470, 471-472 (N.D. Ohio), affirmed *per curiam*, 240 F.2d 843 (C.A. 6th), certiorari denied, 353 U.S. 958; *241 Corp.* v. *Commissioner*, decided July 25, 1956 (1956 P-H T.C. Memorandum Decisions, par. 56,174), affirmed *per curiam*, 242 F.2d 759 (C.A. 2d), certiorari denied, 354 U.S. 938; *May Hosiery Mills* v. *Commissioner*, 123 F.2d 858, 860 (C.A. 4th); *Haffenreffer Brewing Co.* v. *Commissioner*, 116 F.2d 465, 468 (C.A. 1st), certiorari denied, 313 U.S. 567; *Jewel Tea Co.* v. *United States*, 90 F.2d 451, 453 (C.A. 2d).

Moreover, almost every factor considered by the courts as evidencing a stockholding relationship was present. Thus, in addition to the facts that there was no fixed maturity date and no obligation to pay a fixed rate of interest regardless of the taxpayer's income or lack thereof, we have, as previously discussed, the following facts: The advances were left with the business indefinitely and thus completely subject to the risks of the business and, in effect, subordinated to all outside creditors; the advances were (R. 38, 166-168) used generally by the taxpayer to start the operation of its business and to acquire all of its business property; the shareholders who advanced the funds all had the right to vote; all returns on the advances depended upon the success of the business and those who made the advances did not expect a return during bad years; there was never any right, or attempt, to collect interest or principal; and the advances were all unsecured.

In short, all of the characteristics of a stockholding relationship existed at this time, and had so existed for a period of twenty-eight years. Indeed, the only difference between the advances in question and those which were concededly equity investments was that the latter were represented by stock certificates. On the other hand, as we have pointed out, none of the characteristics of a debtor-creditor relationship existed. Hence, as previously noted, as a matter of law, the advances could not at this juncture be considered debts giving rise to deductible interest payments under the Code.

(b) *The status of the shareholder advances from the year 1943 through the taxable years 1953, 1954 and 1955*

The taxpayer asks this Court to ignore the history we have just discussed and relies wholly upon events that occurred in the year 1943 (Br. 9-14, 18, 22), which it apparently believes changed the entire picture. During that year the "Special Accounts Payable" nomenclature was changed to "Bills Payable", and notes were issued for each of the "Special Accounts Payable". The notes were dated January 1, 1943, due one year after date, and bearing interest at the rate of 5%. (R. 41.) The reason for these new formalisms was testified to by the taxpayer's own witness as being the taxpayer's response to notification by an Internal Revenue Agent that interest could only be paid on notes. (R. 153.)

The pertinent inquiry now is to determine whether or not the new formalisms changed the substance of what had existed for the previous 28 years.

First of all, the record discloses that the notes remained in the possession of the taxpayer, thus rendering them for all practical purposes non-negotiable. (R. 53.) In fact, so far as the record shows none of the notes were negotiated. Notwithstanding the absolute provision for interest contained on the notes, the real circumstance was that the noteholders did not determine whether interest could be paid or, if so, the amount of interest that would be paid. The payment of interest and the amount thereof was wholly within the discretion of the taxpayer's directors. (R. 186-187.) The directors exercised their discretion by taking into consideration the earnings of the taxpayer. (R. 53.) Accordingly, the so-called interest payments actually varied, reflecting such consideration. The taxpayer altered the notes without conferring with the holders thereof. (R. 53-54.) Although the notes contained a fixed maturity date of one year, they were in fact never paid. The taxpayer automatically issued new notes each year, marking the old ones as paid, or sometimes merely renewed the old notes. The stockholders who happened to be at the directors' meetings never objected, and other noteholders were never consulted. (R. 53, 101, 142.) The advances continued to be unsecured and none of the noteholders demanded repayment of principal although past due according to the terms of the notes. Accordingly, up to and including the taxable years most of the advances made by shareholders had remained with the corporation for a period of 38 years and other advances made by them likewise remained at the taxpayer's disposal for long-

term periods. The record also shows that interest was not cumulative, and in years when not paid it was lost to the noteholders. (R. 181; Ex. 15-O(a).) Further, the record discloses that outsiders (other than stockholders and members of their immediate families) refused to make advances to the taxpayer under like circumstances, to wit, for an indefinite period of time wholly at the risk of the business, the return thereon being exclusively within the discretion of the directors. (R. 183.) Finally, the record shows that, as in the case of any holders of common or preferred stock, neither the noteholders nor the taxpayer believed that any demand for payment would be made—if such demand were made it could have caused the taxpayer's liquidation. (R. 101, 142, 170.)

We submit that the substance of the transactions in issue was not changed by the issuance of the notes from what it was before that event. The notes did not represent the true agreement of the parties and as before none of the characteristics of the classic debt existed, and almost all of the characteristics inherent in a stockholding relationship continued to exist.

Although it is true that the notes themselves did not confer the right to vote, this factor is of little importance with respect to the stockholders who all had the right to vote and had tacitly agreed since 1915 that voting rights would remain in accord with common stock ownership, while the true equity interests would be represented by the accounts which bore different names through the years. See, for example, *Hoguet Real Estate Corp.* v. *Commissioner*, 30 T.C.

580, 600; *Colony, Inc.* v. *Commissioner*, 26 T.C. 30, 43, affirmed on another issue, 244 F. 2d 75 (C.A. 6th), reversed, 357 U.S. 28. Cf. *Cleveland Shopping News Co.* v. *Routzahn*, 89 F.2d 902 (C.A. 6th).

Moreover, many equity interests (i. e., preferred stock) ordinarily contain no voting rights and are held disproportionately by both holders of common stock and individuals who do not own such stock. However, such equity interests have all of the attributes of the "Bills Payable Account" in this case, and the owners thereof are *not* creditors. *Lee Telephone Co.* v. *Commissioner*, decided December 16, 1957 (1957 P-H T.C. Memorandum Decisions, par. 57,230), affirmed, 260 F.2d 114 (C.A. 4th); *Crawford Drug Stores, Inc.* v. *United States*, 220 F.2d 292, 296 (C.A. 10th); *Green Bay & Western Railroad Co.* v. *Commissioner*, 3 T.C. 372, 379, affirmed, 147 F.2d 585 (C.A. 7th); *Elko Lamoille Power Co.* v. *Commissioner*, 50 F.2d 595, 596 (C.A. 9th); *Huisking & Co.* v. *Commissioner*, 4 T.C. 595, 600.

Under the circumstances disclosed by the record, the only items of evidence that reasonably can be relied upon by the taxpayer are (1) the form of the transactions, and (2) the fact that in later years the taxpayer did not have a debt structure which was greatly in excess of its assets. With respect to the first point, it already has been shown that the notes did not reflect the true relationship of the parties. With respect to the second point, it is exceedingly well settled that no one characteristic is determinative of the present question. Thus, it is uniformly held, for example, in cases where the obligation in-

volved expressly excludes the "creditor" from management and stock investment is not nominal, or where advances are not made in proportion to stockholdings, that the cumulative effect of other circumstances justifies a finding that advances constitute venture capital.[6] The finding that a corporation was thinly capitalized is merely cumulative. Moreover, although the taxpayer initially was not merely thinly capitalized but had *no* capital at all, and although at all times its *form* indebtedness was always greatly disproportionate to its form capital (R. 47-48, 50), the Tax Court did not rely upon those facts directly for its findings. It merely pointed out some of those factors as being circumstances explaining the taxpayer's actions. (R. 50.) As previously noted, the Tax Court was required to consider all factors and, in accordance with that requirement, it reached its findings after a painstaking review of all circumstances, giving no one factor undue significance. (R. 49-56.)

Reviewing the evidence in this case, it is clear that the characteristics of a stockholding relationship overwhelmingly preponderate, while the characteristics of a debtor-creditor relationship are almost nonexistent. Such circumstances as so-called interest

---

[6] *John Kelley Co.* v. *Commissioner,* 326 U.S. 521, 525-530; *Gilbert* v. *Commissioner,* 262 F.2d 512, 513 (C.A. 2d), certiorari denied, 359 U.S. 1002; *Gilbert* v. *Commissioner,* 248 F.2d 399, 410 (C.A. 2d); *Reed* v. *Commissioner,* 242 F. 2d 334, 335 (C.A. 2d); *Gooding Amusement Co.* v. *Commissioner,* 23 T.C. 408, 419, affirmed, 236 F.2d 159 (C.A. 6th), certiorari denied, 352 U.S. 1031; *Dittmar* v. *Commissioner,* 23 T.C. 789, 796.

payments being at the sole discretion of directors and dependent upon the taxpayer's earnings are, of course, not characteristic of an interest obligation but are characteristic of an intent to pay dividends. The facts that there was no fixed maturity date and that advances were allowed to remain with the taxpayer for most of its corporate life disclose that holders of the notes did not intend to enforce payment in any event and that their real position was that of shareholders whose investment is understood to be at the risk of the venture. Further facts in addition to those just mentioned, such as the facts that no demand for payment was made, so-called interest was not cumulative, the notes were not in the possession of those who advanced funds, any attempt to enforce payment of notes would have rendered the taxpayer insolvent, the notes were not secured, etc., clearly disclose that the advances in question constituted venture capital and that the taxpayer's disbursements to noteholders of its profits were dividend payments.[7]

---

[7] Some of the cases deciding that advances to corporations constituted contributions to capital under similar circumstances, although not all having the strong cumulative characteristics of a stockholding relationship contained in the present record, are as follows: *Brinker* v. *United States*, 116 F. Supp. 294, 297 (N.D.Cal.), affirmed *per curiam*, 221 F.2d 478 (C.A. 9th); *Gilbert* v. *Commissioner*, 262 F.2d 512 (C.A. 2d), certiorari denied, 359 U.S. 1002; *Lockwood Realty Corp.* v. *Commissioner*, decided March 31, 1958 (1958 P-H T.C. Memorandum Decisions, par. 58,049), affirmed on this issue, 264 F.2d 241 (C.A. 6th); *Lee Telephone Co.* v. *Commissioner*, decided December 16, 1957 (1957 P-H T.C. Memorandum Decisions, par. 57,230), affirmed, 260

The Tax Court's finding here is therefore plainly not clearly wrong. Indeed, the taxpayer has completely failed to meet its burden of clearly establishing its right to the deductions claimed. (See Point A, *supra.*)

2. *The taxpayer's payments to noteholders who did not hold certificates of stock likewise constitute dividends*

Certain individuals who did not own certificates of stock in the taxpayer owned interests in the taxpayer's "Bills Payable Account". (R. 54.) Most of these, who like the stockholders became noteholders in 1943, had left their advances in the accounts of the taxpayer since the early nineteen hundreds. (R. 37, 43-44.) A great portion of these advances was made for those noteholders by the respective heads of their families who were the formal holders of stock in the taxpayer. (R. 45, 135-136.) These noteholders were members of the Farnsworth and McPherson families, which families controlled at least two-thirds of the taxpayer's stock. (R. 54-55.)

F.2d 114 (C.A. 4th); *Reed* v. *Commissioner,* 242 F.2d 334 (C.A. 2d); *Gooding Amusement Co.* v. *Commissioner,* 23 T.C. 408, affirmed, 236 F.2d 159 (C.A. 6th), certiorari denied, 352 U.S. 1031; *Matthiessen* v. *Commissioner,* 194 F.2d 659 (C.A. 2d); *Universal Oil Products Co.* v. *Campbell,* 181 F.2d 451 (C.A. 7th), certiorari denied, 340 U.S. 850, rehearing denied, 340 U.S. 894; *Prutzman* v. *Commissioner,* decided December 10, 1953 (1953 P-H T.C. Memorandum Decisions, par. 53,400), affirmed *per curiam,* 218 F.2d 603 (C.A. 2d); *Hoguet Real Estate Corp.* v. *Commissioner,* 30 T.C. 580; *Huisking & Co.* v. *Commissioner,* 4 T.C. 595; *Green Bay & Western Railroad Co.* v. *Commissioner,* 3 T.C. 372, affirmed, 147 F.2d 585 (C.A. 7th).

In order to show that the noteholders here described in fact held equity interests in the taxpayer, and that their advances did not give rise to "indebtedness" within the meaning of Section 23(b), extended discussion is not necessary because the true circumstances underlying the formalisms are precisely the same as those previously discussed with respect to the "stockholders" who also held notes. As was the case with those who held certificates of stock, the following characteristics here prevailed: The notes under discussion were *in fact* not negotiable (the notes always remained in the taxpayer's possession); there was in fact no fixed date for payment of interest and for repayment of principal; payments were in the sole discretion of directors and depended upon earnings; there was no attempt to enforce payment although formal due dates were never complied with; there was no security; the advances remained with the taxpayer invested in its business assets for almost the entire period of its corporate existence; the individuals who made the advances were aware of the fact that the terms of the notes were mere formalisms and that the true characteristics were those which we have just described, etc. (R. 51, 53-54, 135-137, 142, 144, 169-170, 186-187.)

In other words, here, too, almost all of the characteristics of a stockholding relationship exist and almost none of the recognized characteristics of a debtor-creditor relationship are in fact to be found.

Although the notes did not specifically confer the right to vote or participate in management, the noteholders who did not hold common stock in fact had

a representative on the board of directors. (R. 46, 54.) Furthermore, the interests of these noteholders bore the substantial earmarks of equity interests, and the lack of voting rights under the record facts merely puts the noteholders in the same status as preferred stockholders. See discussion and cases cited under Point B-1, *supra*.

Of course, at this late date it would be trite to contend that individuals cannot be deemed to be possessed of equity or stock interests in a corporation merely because none of the formalisms have been observed. If advances are such that they are accompanied with a preponderance of characteristics which accord with a stockholding relationship, the holder of notes representing those advances is treated as a stockholder under the Code. *O'Neill* v. *Commissioner*, decided October 11, 1957 (1957 P-H T.C. Memorandum Decisions, par. 57,193), affirmed, 271 F.2d 44 (C.A. 9th); *Lee Telephone Co.* v. *Commissioner*, decided December 16, 1957 (1957 P-H T.C. Memorandum Decisions, par. 57,230), affirmed, 260 F.2d 114 (C.A. 4th); *Universal Oil Products Co.* v. *Campbell*, 181 F.2d 451, 476-477 (C.A. 7th), certiorari denied, 340 U.S. 850, rehearing denied, 340 U.S. 894; *Green Bay & Western Railroad Co.* v. *Commissioner*, 3 T.C. 372, 379, affirmed, 147 F.2d 585 (C.A. 7th); *Kalech* v. *Commissioner*, 23 T.C. 672, 681-682; *Huisking & Co.* v. *Commissioner*, 4 T.C. 595, 599-600; *Thomas* v. *Commissioner*, 2 T.C. 193, 196; *Gale* v. *Commissioner*, decided April 30, 1956 (1956 P-H T. C. Memorandum Decisions, par. 56,103). Hence, the disbursements made by the taxpayer to those noteholders

who did not formally hold certificates of stock were, under the circumstances disclosed by this record, dividends not deductible as interest under Section 23(b) of the 1939 Code as the Tax Court properly held. (R. 48, 56.)

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

Charles K. Rice,
Assistant Attorney General,

Lee A. Jackson,
Robert N. Anderson,
Melvin L. Lebow,
Attorneys,
Department of Justice,
Washington 25, D. C.

February, 1960.

☆ U. S. GOVERNMENT PRINTING OFFICE; 1960 541583 1121